No. 94-1292

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In the Supreme Court of the United States

OCTOBER TERM, 1994

BRUCE BABBITT, SECRETARY OF THE INTERIOR, ET AL., PETITIONERS

v.

PHILLIPS PETROLEUM COMPANY AND ATLANTIC RICHFIELD COMPANY, RESPONDENTS

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF OF PHILLIPS PETROLEUM COMPANY IN OPPOSITION

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QUESTION PRESENTED

Whether the Department of the Interior may enforce an unpublished standard that contradicts the published regulation governing the calculation of natural gas royalties — and thus may collect both additional royalties and late payment charges from federal oil and gas lessees that have failed to pay royalties in accordance with the unpublished standard — without first complying with the notice-and-comment provisions of the Administrative Procedure Act, 5 U.S.C. § 553.

RULE 29.1 STATEMENT

Phillips Petroleum Company has no parent company and has the following non-wholly owned subsidiaries:

Alyeska Pipeline Service Company
Arctic LNG Transportation Company
Bissendorf Biosciences GmbH
Canyon Reef Carriers, Inc.
Chisholm Pipeline Company
Colonial Pipeline Company
Cristal Ltd.
Dixie Pipeline Company
Eagle Sun Company Ltd.
East Texas Salt Water Disposal Company
Explorer Pipeline Company
FLTG Inc.
Heat Transfer Research, Inc.
Kenai LNG Corporation
Multinational Gas and Petrochemical Services Ltd.
Norland GmbH für Grundbesitz und Industrieanlagen
Norpipe A.S.
Norpipe Petroleum UK Ltd.
Norsea Gas A/S
Norsea Gas GmbH
Norsea Pipeline Ltd.
Oil Casualty Insurance Ltd.
Oil Insurance Ltd.
Phillips-Imperial Petroleum Ltd.
Phillips Gas Company
Phillips Morrison Resources Ltd.
Phillips P.C. Resources Ltd.
Phillips Petroleum Singapore Chemicals (Private) Ltd.
Phillips Sumika Polypropylene Company (Partnership)
Phillips-San Juan Partners, L.P.
Piro Implementation, Inc.
Polar LNG Shipping Corporation

Prince William Sound Oil Spill Response Corporation
Renolit-Haus AG
Renolit-Haus GmbH
Southern and Phillips Gas Limited
Sweeny Olefins Limited Partnership
Venezoil, C.A.
Western Desert Operating Petroleum Company
(WEPCO)

TABLE OF CONTENTS

Page

STATEMENT 2

ARGUMENT 6

A. The Petition Should Be Denied Because the Spot-Price Rule Is Subject to APA Notice-and-Comment Procedures Under Any Reasonable Standard 6

1. The Spot-Price Rule Is Not a "Rule[] of Agency * * * Procedure" Because It Regulates the Primary Conduct of Private Parties 7

2. The Procedure Paper Did Not Interpret But Rather Contradicted the Governing Published Regulation 10

B. The Unusual Context of the Decision Below Limits Its Effect and Makes It a Poor Vehicle for Resolving Questions Under the Administrative Procedure Act 12

C. The Government's Petition Confirms the Importance of the Petition in No. 94-1287, Which Should Be Granted Regardless of the Disposition of the Government's Petition 13

CONCLUSION 15

TABLE OF AUTHORITIES

Page

Cases

American Mining Congress v. *Mine Safety & Health Administration*, 995 F.2d 1106 (D.C. Cir. 1993) 11

Batterton v. *Marshall*, 648 F.2d 694 (D.C. Cir. 1980) 9

Brown Express, Inc. v. *United States*, 607 F.2d 695 (5th Cir. 1979) 7, 9

Chrysler Corp. v. *Brown*, 441 U.S. 281 (1979) . . . 6, 10

Department of Transportation v. *Air Transport Ass'n*, 498 U.S. 1023 (1991), vacated and remanded, 498 U.S. 1077, dismissed as moot, 933 F.2d 1043 (D.C. Cir. 1991) 8

Friedrich v. *Secretary of HHS*, 894 F.2d 829 (6th Cir.), cert. denied, 498 U.S. 817 (1990) 9

General Motors Corp. v. *Ruckelshaus*, 742 F.2d 1561 (D.C. Cir. 1984), cert. denied, 471 U.S. 1074 (1985) 9

Industrial Safety Equipment Association v. *EPA*, 837 F.2d 1115 (D.C. Cir. 1988) 8

JEM Broadcasting Co., Inc. v. *FCC*, 22 F.3d 320 (D.C. Cir. 1994) 9

Metropolitan School District v. *Davila*, 969 F.2d 485 (7th Cir. 1992) 9-11

Phillips Petroleum Co. v. *Lujan*, 963 F.2d 1380 (10th Cir. 1992) 5

TABLE OF AUTHORITIES — Continued

Pages

Reeder v. *FCC*, 865 F.2d 1298 (D.C. Cir. 1989) 9

Shalala v. *Guernsey Memorial Hospital*, 115 S. Ct. 1232 (1995) 10, 12

Southern California Edison Co. v. *FERC*, 770 F.2d 779 (9th Cir. 1985) 9

State of Ohio Department of Human Services v. *United States Department of HHS*, 862 F.2d 1228 (6th Cir. 1988) 10

Vermont Yankee Nuclear Power Corp. v. *Natural Resources Defense Council, Inc.*, 435 U.S. 519 (1978) 8

Statutes and Regulations

5 U.S.C. § 553 . . . . . 6, 10, 11

28 U.S.C. § 2415(a) 7, 12

43 U.S.C. §§ 1331-1356 2

43 U.S.C. § 1339 7

30 C.F.R. pt. 206 2

30 C.F.R. § 206.150 (1987) 3, 4, 11, 12

30 C.F.R. § 206.150-.159 (1994) 4, 11, 12

30 C.F.R. § 206.151 4

30 C.F.R. § 206.153(c)(2) (1994) 4

30 C.F.R. § 218.150 3

TABLE OF AUTHORITIES — Continued

Pages

Miscellaneous

Oil and Gas and Sulphur Operations in the Outer Continental Shelf, 44 Fed. Reg. 13,527 (1979) 11

Revision of Gas Royalty Valuation Regulations and Related Topics, 53 Fed. Reg. 1230 (1988) 12

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BRIEF OF PHILLIPS PETROLEUM COMPANY IN OPPOSITION

The government's petition seeks review of a different aspect of the same case that is the subject of Phillips' petition, No. 94-1287, which presents the question whether any statute of limitations applies to government claims that an oil, gas, or other mineral lessee has underpaid royalties. While we believe that the question presented in Phillips' petition merits this Court's review, we submit that, for the reasons that follow, the government's petition should be denied.

The government's petition skirts but cannot avoid the compelling fact that counsels against this Court's review: the agency directive invalidated by the court of appeals both dictated the primary conduct of private parties, *i.e.*, federal natural gas lessees, and contradicted the published regulation that properly applied to the calculation of royalties on federal

natural gas leases. Under any reasonable standard, the court of appeals properly held that the directive could not be applied against respondents because the Secretary had failed to comply with the notice-and-comment provisions of the Administrative Procedure Act ("APA"). Any conflict in the approaches of the various courts of appeals regarding the need for notice and comment accordingly would not affect the outcome of this case.

In addition, the mineral leasing context of this case places the government in a position that differs significantly from its typical role in administrative law cases. The government is both regulator and contractual party, and the spot-price rule at issue in this case not only determined the substance of agency decisions but defined the contractual obligations of private parties. These unique complications make this case an unsuitable vehicle for reviewing broader issues under the APA.

Respondent Phillips Petroleum Company adopts and incorporates herein by reference the Statement and Argument set forth in the Brief of Atlantic Richfield Company in Opposition ("Arco Opp."). We add the following comments.

STATEMENT

1. The holder of a natural gas lease issued under the Outer Continental Shelf Lands Act (43 U.S.C. §§ 1331-1356) must pay royalties on the value of all minerals produced from the lease. The production of some natural gas often results in the production of certain associated hydrocarbons. These "natural gas liquid products," or "NGLPs," include ethane, propane, iso-butane, N-butane, and natural gasoline.

The lessee is responsible for paying all royalties on a monthly basis. The government, however, generally has a contractual right to determine the value of production on which royalties must be paid. The government exercises that

right pursuant to the extensive regulations governing "product valuation." 30 C.F.R. pt. 206.

Because natural gas royalties generally are a percentage of the value of production, the calculation of that value amounts to a calculation of the royalties due. The government makes that determination, if at all, *post hoc* in an audit of past royalty payments. If the government determines that a lessee has undervalued past production and thus has underpaid past royalties, the lessee is liable not only for the past-due royalties but also for late payment charges. See, *e.g.*, Pet. App. 83a; 30 C.F.R. § 218.150.

Lessees accordingly are placed at a significant financial risk of misgauging the government's later assessment of the reasonable value of production from a lease. As a result, it behooves lessees to calculate the value of production using the same method that the Interior Department is likely to use, as reflected in the published regulations governing the calculation of the value of production.

2. During the period relevant to this case, the regulation applicable to NGLPs established two floors for the value of production: (1) "fair market value," and (2) the actual proceeds to the lessee. 30 C.F.R. § 206.150 (1987). The Director of the Minerals Management Service of the Department of the Interior ("MMS") had the duty to compute the value of production for particular units. The regulation set specific guidelines for this determination:

> In establishing the value, the Director shall consider: (a) The highest price paid for a part or for a majority of like-quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the proceeds accruing to the lessee from the disposition of the produced substances

> or less than the value computed on the reasonable unit value established by the Secretary.

30 C.F.R. § 206.150 (1987) (designated as 30 C.F.R. § 250.643 until August 1983).

The MMS apparently was unsatisfied with the application of the regulation's five-factor test to NGLPs that either were used directly by the lessee or were sold to an affiliate of the lessee. The Interior Department did not modify the regulation in the first instance, however. Instead, in late 1984 and early 1985, the MMS promulgated a "Procedure Paper on Natural Gas Liquid Products Valuation." Pet. App. 128a-145a. The Procedure Paper did not mention Section 206.150. Instead, the Paper stated that in most circumstances, the MMS would establish the reasonable unit value of NGLPs that were not transferred pursuant to arm's-length contracts by looking to a single source: "spot prices," as reported in specific commercial price bulletins for each NGLP, time period, and geographic area. The Procedure Paper was not by its terms limited to prospective application.

Spot prices are not the same as the "posted prices" identified in Section 206.150. See Pet. App. 11a n.4. The differences were made clear in 1988 when the Interior Department finally promulgated new regulations that superseded both Section 206.150 and the Procedure Paper. See 30 C.F.R. § 206.150-.159 (1994). The new regulation specifically permits the use of "prices received in spot sales" in valuing NGLPs, and clearly distinguishes spot prices from "posted prices." *Id.* § 206.153(c)(2); see *id.* § 206.151 (separately defining "posted price" and "spot sales agreement"). The difference is not trivial: posted prices are the prices that buyers routinely offer on a regular and continuing basis, while spot prices result from purchases by those buyers with immediate (and price-enhancing) needs.

3. In an order issued September 27, 1989, the MMS stated that, because Phillips had not used the method set out

in the Procedure Paper, it had undervalued NGLPs that were used internally without being sold. The order required Phillips to recalculate and pay royalties on all of its offshore leases from January 1977 through February 1988. Pet. App. 78a-85a.

The MMS self-audit and payment order issued to Phillips made clear that for all non-arm's-length NGLP transactions, the lowest published spot price was in fact the minimum value permitted. Pet. App. 81a-82a. The order assumes that the value of production for all non-arm's-length contracts will equal or exceed the relevant spot price. Indeed, as the district court later recognized, the MMS in effect required Phillips to use reported spot prices as the "formulas" to compute the proper royalties. Pet. App. 43a. The predictability (and inflexibility) that result from the treatment of spot prices as "royalty calculation formulas" is the entire basis for the finding of "systemic deficiencies" that alone can justify the broad compulsion of a lessee to revisit years of accounts. See Pet. App. 41a-45a; *Phillips Petroleum Co.* v. *Lujan*, 963 F.2d 1380, 1386 (10th Cir. 1992).

Rather than appealing the MMS orders within the Department of the Interior, Phillips filed suit in the United States District Court for the Northern District of Texas in October 1989.[1] Phillips sought a declaratory judgment that the order was invalid and an injunction against its enforcement. The action was consolidated with lawsuits challenging two other royalty payment orders that the MMS had issued to Phillips, and a similar action filed by the Atlantic Richfield Company. Pet. App. 21a-22a. The consolidated action followed the course set out in the Arco Opp.

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[1] The parties agreed that the MMS orders were final for the purpose of judicial review. Pet. App. 22a n.6.

ARGUMENT

The petition recites and examines the exceptions to the notice-and-comment requirements of the APA in an effort to distract the Court from the fundamental nature of the spot-price rule — and the fundamental soundness of the decision below on the notice-and-comment issue. Thus, the petition simply ignores what it cannot controvert: the controlling characteristic of the spot-price rule is that it compels lessees to pay royalties measured against spot prices, or face substantial late payment charges. Under these circumstances, the Fifth Circuit unquestionably was correct that the MMS could not enforce the spot-price rule without first subjecting it to public notice and the opportunity for comment mandated by the APA. Moreover, because many of the circumstances compelling that conclusion are unique to the mineral leasing context, this case is a poor vehicle for this Court to review the broader APA issues discussed in the petition.

A. The Petition Should Be Denied Because the Spot-Price Rule Is Subject to APA Notice-and-Comment Procedures Under Any Reasonable Standard

The petition does not advance a standard for distinguishing rules that are subject to the notice-and-comment requirement of the APA from those that are not. The omission is revealing. As this Court has observed, 5 U.S.C. § 553 effectively distinguishes between, on the one hand, substantive rules that are subject to public notice and the opportunity for comment, and on the other hand, agency pronouncements that are restricted to matters of procedure or that simply elaborate upon existing rules without imposing new or different legislative requirements on their own. *Chrysler Corp.* v. *Brown*, 441 U.S. 281, 301-302 (1981). Under any standard, the spot-price rule in the Procedure Paper, as applied and enforced by the MMS, is a substantive rule that may not be promulgated and enforced without notice and comment. That conclusion is compelled by the facts of this

case and does not depend on the application or the contours of the "substantial impact" test advanced in *Brown Express, Inc.* v. *United States*, 607 F.2d 695, 702 (5th Cir. 1979).

1. *The Spot-Price Rule Is Not a "Rule[] of Agency * * * Procedure" Because It Regulates the Primary Conduct of Private Parties*

a. This case presents an unusual situation in which agency action affects — indeed, defines — the contractual duties of private parties. The MMS's adoption of a royalty calculation method for its auditors in fact establishes the royalties that lessees are obligated to pay under their leases.

The government admits that, "[a]s a practical matter, * * * lessees track and report their own production, its value, and the royalties due thereon." Pet. 7. The method that the government uses to evaluate the sufficiency of royalty payments thus dictates any rational lessee's calculation of royalties at the time of payment; the price of correcting underpayments, with interest, far exceeds any potential saving. This is especially true because lessees must claim any royalty overpayment within two years, 43 U.S.C. § 1339, while the government has at least six years to collect underpayments, 28 U.S.C. § 2415(a) — if not forever, as the court below held in the ruling that we have challenged in our petition in No. 94-1287. Thus, if the MMS's method of calculation results in a decision that royalties have been underpaid in some months but overpaid in others, the lessee will be liable for all the underpayments but in most circumstances will be time-barred from recovering any overpayments.

The spot-price rule does not merely set forth a procedure to be followed when the MMS audits royalty payments, but dictates the substantive criteria for a decision as to the adequacy of royalties. By substituting a different standard for royalty calculations, the Procedure Paper impermissibly "narrow[s]" and "alter[s]" the substantive "grounds on which the [MMS] will act" in demanding additional royalties

(*Industrial Safety Equipment Association* v. *EPA*, 837 F.2d 1115, 1120 (D.C. Cir. 1988)) — and, therefore, the substantive standards on which an informed lessee will calculate and pay royalties in the first instance. In other words, the spot-price rule must be followed not merely by government auditors, but by all federal natural gas lessees who wish to avoid underpaying royalties and incurring late payment charges. The spot-price rule clearly is a rule that private parties (*i.e.*, lessees) "must obey"; it therefore was subject to the notice-and-comment requirements of the APA. *Id.* at 1121.

Accordingly, the petition cannot succeed in its strained attempt (at 23-24) to draw analogies between this case and both *Vermont Yankee Nuclear Power Corp.* v. *Natural Resources Defense Council, Inc.*, 435 U.S. 519 (1978), and *Department of Transportation* v. *Air Transport Ass'n*, 498 U.S. 1023 (granting certiorari to 900 F.2d 369 (D.C. Cir. 1990)), vacated and remanded, 498 U.S. 1077, dismissed as moot, 933 F.2d 1043 (D.C. Cir. 1991). Both *Vermont Yankee* and *DOT* v. *ATA* involved challenges to agency rules that dealt unambiguously with matters of procedure. The question in *Vermont Yankee* was the extent to which courts could force an agency to engage in proceedings that were concededly beyond those required by the APA. In *DOT* v. *ATA*, a court of appeals had required notice-and-comment procedures for an agency's rules governing discovery, settlement, and hearing procedures.

Here, by contrast, it is not a "procedural device[]" (*Vermont Yankee*, 435 U.S. at 546) but a rule of decision that is at issue. The spot-price rule means that, in the vast majority of cases, the agency will order the payment of back royalties and late payment charges by lessees who failed to use that source in computing their royalty obligations. That is a matter not of procedure, but of substance.

b. What dooms the government's position in this case is not the "substantial impact" test, but another, universally accepted proposition from *Brown Express*: "[T]he label that the particular agency puts upon its given exercise of administrative power is not * * * conclusive; rather it is what the agency does in fact." Pet. App. 7a (quoting *Brown Express*, 607 F.2d at 700). The courts cited in the petition (at 24 & n.8) as rejecting or retreating from the "substantial impact" test nonetheless agree that the government cannot secure immunity from APA rulemaking requirements simply by couching substantive standards of private conduct in terms of the agency's review of that conduct. See, *e.g.*, *JEM Broadcasting Co., Inc.* v. *FCC*, 22 F.3d 320, 326-328 (D.C. Cir. 1994); *Metropolitan School District* v. *Davila*, 969 F.2d 485, 489 (7th Cir. 1992); *Friedrich* v. *Secretary of HHS*, 894 F.2d 829, 834-835 (6th Cir.), cert. denied, 498 U.S. 817 (1990); *General Motors Corp.* v. *Ruckelshaus*, 742 F.2d 1561, 1565 (D.C. Cir. 1984) (en banc), cert. denied, 471 U.S. 1074 (1985).

In the D.C. Circuit, the "procedural" label is reserved for those rules that "do not themselves alter the rights or interests of parties," but merely "alter the manner in which the parties present themselves or their viewpoints to the agency." *JEM Broadcasting*, 22 F.3d at 326 (quoting *Batterton* v. *Marshall*, 648 F.2d 694, 707 (D.C. Cir. 1980)). Rules that, like the spot-price rule, "change[] the substantive criteria" that an agency applies are not procedural and are not exempt under Section 553(b). *Reeder* v. *FCC*, 865 F.2d 1298, 1305 (D.C. Cir. 1989).

The Ninth Circuit agrees that the notice-and-comment requirements apply to rules that "implement existing law [by] imposing general, extrastatutory obligations" and thus "affect the substance" of an agency determination. *Southern California Edison Co.* v. *FERC*, 770 F.2d 779, 783 (9th Cir. 1985). The spot-price rule — which creates an obligation to pay royalties based on a value of production that is no less

than the lowest relevant spot price — does not merely "affect" but in fact dictates the substance of an MMS evaluation of a royalty's sufficiency.

Under Seventh Circuit law, the spot-price rule creates "new * * * duties" by requiring lessees to pay royalties based on a single source of spot prices rather than on the broader and more flexible criteria set out in the regulation. *Davila*, 969 F.2d at 490. And, under the Sixth Circuit's standard, the spot-price rule is clearly "mandatory, not advisory." *State of Ohio Department of Human Services* v. *United States Department of HHS*, 862 F.2d 1228, 1234 (6th Cir. 1988). It imposes an effective floor on what may constitute the "value of production" (or its "fair market value") under the regulation. See *ibid.* (notice-and-comment provisions applied to a rule that "imposed a ceiling *ex proprio vigore*" on a benefit, where the published regulation did not include the ceiling).

In sum, under any reasonable analysis, the spot-price rule is a substantive rule subject to the notice-and-comment provisions of Section 553; indeed, that rule is precisely the kind that would most benefit from the "mature consideration of rules of general application" that consultation with affected parties was intended to produce. *Chrysler Corp.*, 441 U.S. at 303. This case is thus an inappropriate vehicle for fine-tuning the analysis of the statutory standard.

2. *The Procedure Paper Did Not Interpret But Rather Contradicted the Governing Published Regulation*

There is another reason why the spot-price rule had to be promulgated under the notice-and-comment procedures of the APA. This Court recently held that "APA rulemaking [is] required" when an agency rule "adopt[s] a new position inconsistent with * * * existing regulations." *Shalala* v. *Guernsey Memorial Hospital*, 115 S. Ct. 1232, 1239 (1995). The spot-price rule was inconsistent with and effectively superseded the five-factor test set forth in the governing

regulation, 30 C.F.R. § 206.150. Just as APA rulemaking was required for promulgation of Section 206.150,[2] so was it necessary for its successor.

The spot-price rule is not an interpretative rule. The MMS did not "rel[y] upon the language of the statute and its legislative history," or on the governing regulation, in order to state "what it thinks the [regulation] requires." *Davila*, 969 F.2d at 492. In announcing the spot-price rule, the Procedure Paper did not even acknowledge the existence of Section 206.150, much less purport to interpret the published regulation. And in direct contravention of the express terms of the regulation, the Procedure Paper itself did not take "posted prices" into account at all.

Indeed, the spot-price rule forbids consideration of posted prices or the other factors enumerated in the regulation. Quite clearly a royalty calculation might comply with the published regulation but not with the unpublished spot-price rule. As a result, the spot-price rule "effectively amends a prior legislative rule," and therefore is subject to the notice-and-comment requirements of Section 553. *American Mining Congress* v. *Mine Safety & Health Administration*, 995 F.2d 1106, 1112 (D.C. Cir. 1993).

The Department was free to make the substantive judgment that "spot prices * * * are a better indicator of value than posted prices" (Pet. App. 106a). Because "posted prices" and not "spot prices" were listed among the factors to be considered under Section 206.150, however, this change to exact increased royalties could come only through an amendment of the regulation using the APA procedures that the Department eventually followed, not through per-

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[2] See Oil and Gas and Sulphur Operations in the Outer Continental Shelf, 44 Fed. Reg. 13,527 (1979) (notice of proposed rulemaking for, *inter alia*, 30 C.F.R. § 250.643, later redesignated § 206.150)).

emptory and unilateral action. See *Shalala*, 115 S. Ct. at 1239.

B. The Unusual Context of the Decision Below Limits Its Effect and Makes It a Poor Vehicle for Resolving Questions Under the Administrative Procedure Act

The effect of the decision below is not so sweeping as the government suggests. Most regulations that nominally pertain to agency procedure do not in fact create substantive rules of decision or dictate the course of action private parties must take independently of their dealings within the agency. The mineral lease royalty setting is highly unusual: agency action determines the extent of a private party's contractual liability to the government. In addition, the MMS has demonstrated that it can easily promulgate notice-and-comment regulations that alert lessees to the precise methods that will be used to calculate the value of production on which royalties must be paid — as it did in the 1988 regulations that superseded both Section 206.150 and the Procedure Paper. See 30 C.F.R. §§ 206.150-.159 (1994).

The mineral leasing context raises unusual issues because of the government's hybrid role as both regulator and contractual party. As a result, this case is peculiarly inappropriate as a vehicle for broadly examining agency rulemaking under the APA.

Moreover, the Secretary's claim (Pet. 26) that the decision below impairs his ability to conduct the mineral royalty management program should be taken with a large grain of salt. First, because the Procedure Paper was superseded in 1988, its validity has no continuing effect on that program. Second, when the Department ultimately decided to comply with the APA when changing its product valuation methods, it found little difficulty in promulgating detailed new regulations. See Revision of Gas Royalty Valuation Regulations and Related Topics, 53 Fed. Reg. 1230 (1988) (codified, *inter alia*, at 30 C.F.R. 206.150-.159); *id.* at 1231

(recognizing the need for continuing "timely revisions to regulatory provisions" in order "to alleviate problems"). The Secretary's apocalyptic warnings are unfounded.

C. The Government's Petition Confirms the Importance Of the Petition in No. 94-1287, Which Should Be Granted Regardless of the Disposition of the Government's Petition

The Fifth Circuit's decision generated another certiorari petition: Phillips' petition in No. 94-1287. In that petition we ask this Court to review the lower court's determination that the general six-year statute of limitations for contract actions brought by the government, 28 U.S.C. § 2415(a), did not apply to MMS royalty collection actions.[3] Our petition demonstrates that, unlike the APA issue, the statute of limitations issue merits review by this Court.

Indeed, the order against Phillips that is the subject of the government's petition illustrates the extremes to which the MMS is willing to push its asserted (and, in the Fifth Circuit, confirmed) ability to seek stale, allegedly underpaid royalties from lessees. Although the Procedure Paper itself acknowledged that the six-year limitation applied (Pet. App. 131a), the 1989 order required Phillips to recalculate and to pay royalties dating back to January 1977—*12¾ years* before the administrative payment order was issued and *15¾ years* before the government asserted a counterclaim in district court to enforce payment of the alleged contractual liability. See No. 94-1287 Pet. 7-8 & Pet. App. 30a-31a. The government's position on the two issues amounts to a claim that it may amend lease royalty regulations without first seeking the views of those affected by its action, and then enforce the terms of the amendment against lessees to collect

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[3] In response to the government's petition, Atlantic Richfield Company filed a cross-petition (No. 94-1479) on the same statute of limitations issue.

additional royalties on production that occurred in the distant past. It would be especially unjust for this Court to deny review of the statute of limitations issue while raising the possibility of validating the Department's enforcement of the spot-price rule.

Moreover, the combination of the two issues in one case presents a valuable opportunity to conserve judicial resources. Both issues involve the government's attempt to abuse the special position of the Interior Department and the MMS in the mineral leasing program in order to subject private parties to substantial and unjust liabilities. The statute of limitations question results from the government's effort to transform the MMS's ability to issue administrative orders in the course of pursuing its contract claims into a device for removing mineral lease contracts from the scope of the general statute of limitations for contract claims brought by the government. The APA question arises from the government's effort to use the fact that a government agency audits royalties as the premise for imposing substantive requirements on royalty payors that are superficially disguised as mere guidelines for the agency's auditors.

Because the Fifth Circuit correctly decided the APA issue in this unique context, it would be inappropriate to grant review of the question presented in the government's petition. A grant of certiorari in response to the government's petition, however, makes a grant of Phillips' petition all the more necessary in order to avoid injustice.

CONCLUSION

The petition for a writ of certiorari should be denied. If the petition nevertheless is granted, the petition in No. 94-1287 should be granted and heard together with this case.

Respectfully submitted.

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